Tax Reform in the (Inter) National Interest: Why Wait? A Response to Professor Avi-Yonah

To the Editor:

In a recent letter to the editor,[1] Prof. Reuven Avi-Yonah made two proposals for U.S. corporate and international income tax reform. His long-term proposal was to simplify corporate taxation by allowing corporations to deduct all capital expenditures, which he characterized as a cash flow or consumption tax on corporations. His mid-term proposal was to move international corporate taxation more toward a pure source-based tax on income. He would implement this latter proposal by adopting formulary apportionment of worldwide income.

I am in complete agreement with Prof. Avi-Yonah that a territorial expenditure tax should be adopted, but I believe that the implementation of an international territorial expenditure tax for corporations should not wait but should be given immediate consideration by Congress and the president.[2] This is the solution that I presented in an earlier work on the basis that an international territorial expenditure tax is the optimal international tax system.[3] I also question whether Prof. Avi-Yonah's proposed implementation of a pure, sourced-based tax by formulary apportionment is consistent with his first proposal for an expenditure tax for corporations. Moreover, although formulary apportionment adopted internationally would improve on the present chaotic state of international taxation, which is based on confusing and economically unsound sourcing rules, formulary apportionment based on present concepts of income taxation is ultimately only another indirect method of assigning territorial tax jurisdiction and lacks the critical elements of economically sound taxation. In contrast, a territorially applied expenditure tax can achieve the overhaul of the international tax system in a way that will promote the goal of raising revenue in an efficient and internationally equitable manner.[4]

1. The case for the territorial implementation of an expenditure tax on corporations. Every nation faces the same problem. How can a nation tax business income in a world where economic forces unleashed by freer trade and enhanced mobility of many factors of production have led to intense tax competition among nations? Taxing a nation's enterprises cannot be separated from consideration of international consequences because domestic taxation is interrelated and dependent on the consequences of international tax rules. Because there is an international consensus that territorial or source taxation is a more fundamental jurisdictional basis for taxation than residence-based taxation, significant insight into taxing business income can be gained by starting the analysis with the jurisdictional basis and economic justification for taxing the business income of a nonresident.

It is a sensible assumption that *people*, not corporations or business activities, are the only true residents for tax purposes. When one applies this logic and concludes that "domestic" corporations should not be taxed as residents for income tax purposes, personal taxation based on ability to pay is inappropriate because it is a residence-based, *in personum* theory of appropriate tax responsibility. Corporations, therefore, should only be taxed on the basis of the benefits received (or public costs associated with their activities).[5] The underlying justification for corporate taxation is therefore an exchange theory of taxation; the only appropriate jurisdictional basis for taxation is *in rem* taxation, which is taxation based on the connection of the income with the particular nation.[6]

The present international tax system starts with the territorial allocation of taxing rights on the basis of rules for the sourcing of income. These rules are inconsistent, and in many cases are founded on policy choices that are economically unsound and are largely unobtainable.[7] The most important error these rules make is their

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[1]Reuven Avi-Yonah, "Tax Reform in the (Multi) National Interest," *Tax Notes*, July 27, 2009, p. 389, *Doc 2009-16391*, *2009 TNT 141-16*.

[2]I prefer the use of the term expenditure tax to the term broad-based consumption of cash flow tax to distinguish this tax from the VAT which is a consumption tax similar to a sales tax.

[3]*See* William B. Barker, "An International Tax System for Emerging Economies, Tax Sparing and Development: It Is All About Source," 22 *Penn J. Int'l. L.* 349 (2007).

[4]*See* Barker, "Optimal International Taxation and Tax Competition: Overcoming the Contradictions," 22 *Nw. J. Int'l. L. & Bus.* 161 (2002). In "Optimal International Taxation," I demonstrated that there is no necessary conflict in operation between capital export neutrality (CEN) which is a residence concept of taxation and capital import neutrality (CIN) which is a territorial concept of taxation. The reason is that each operates efficiently in different spheres, CEN (residence principle) which reflects the optimal tax for capital income and CIN (source principle) which leads to the optimal tax system for economic rents. *Id.* at 188-197.

[5]Prof. Avi-Yonah, in his description for the justification for taxing corporations can be said to treat a corporation as a nonresident for tax purposes, whether or not that corporation has any of the traditional ties that are generally accepted as indices of corporate residence like place of incorporation, seat, principle place of business, and so forth. Avi-Yonah, *supra* note 1, at 389-390.

[6]*See* Barker, *supra* note 4, at 145-197.

[7]*Id.*, at 184 et seq.

assumption that the income from imported capital is appropriately taxed by the host nation. Instead, income from capital can only be taxed fairly and practically under a residence principle by the home state.

The result is that hosts cannot, and should not, seek to tax a corporate enterprise on the normal return from imported capital.[8] Removing capital income from the taxable base of the enterprise leaves the taxation of economic rents that arise in the host nation. Prof. Avi-Yonah is correct that economic rents are the only appropriate basis for territorial corporate taxation.

An expenditure tax is a tax on economic rents. One should note that simply allowing corporations to deduct capital expenditures (as in Prof. Avi-Yonah's recommendation) does not change an income tax into an expenditure tax. Income tax systems and expenditure tax systems also differ in their treatment of debt. Income tax systems allow loan proceeds to be currently included in expenditures and interest to be currently deductible. An expenditure tax system can take one of two forms, an R- and an R&F-type model. "The basic R-type model starts with a comprehensive income tax base and allows immediate deductions for the costs of all materials, labor, and fixed assets. Under the R-base, the recipient of interest and dividends is not taxed, whereas the payor is not entitled to a deduction. The modified R & F type changes the treatment of financial instruments. Loans (and equity) are deductible by the creditor and included in the income of the debtor, and repayments are income to the creditor and deductible by the debtor."[9] Deducting capital expenditures coupled with an income tax system's treatment of debt is a hybrid system that results in a greatly diminished tax base. The example that Prof. Avi-Yonah uses of the case of the United Kingdom[10] was, in fact, a hybrid system which allowed 100 percent capital allowances (the United Kingdom term for depreciation), while still treating debt under income tax principles, not consumption tax principles.

2. Formulary apportionment as an international solution. Prof. Avi-Yonah's mid-term proposal for formulary apportionment is not an expenditure tax model, however, and is not designed to identify economic rents attributable to a particular location. Although it could address some of the problems for the taxation of corporations for the United States, it would have an unfair impact on corporations unless these principles were adopted by nations worldwide because there would be significant opportunities for double taxation without any mechanisms for tax relief. There could also be gaps. Because it is not an expenditure tax, the formulary apportionment of the income tax base would include the apportionment to foreign sources of part of the income from capital. Because host nations have neither the economic justification nor the power to tax the income from imported capital, this would not create a fair division of the tax base and it would stimulate avoidance strategies.[11]

3. The superiority of an expenditure tax over an income tax as an international solution. Formulary apportionment is not the optimal solution. An expenditure tax is vastly superior for achieving an economically efficient and just outcome because it is the practically and theoretically exact way of determining and assessing economic rents.[12] By implementing an expenditure tax, a country unilaterally would automatically tax only its proper share of the corporation's income — *no more* and *no less*. The advantages are enormous. An expenditure tax for corporate taxpayers internationally creates an economically efficient, fair allocation of a corporation's income worldwide. Due to the clear economic nexus between economic rents and the source country, the source country will have a more certain source of tax revenue. Residence countries that refrain from taxing foreign economic rents truly give up nothing, because they would give up a tax base that was created by the attributes of the source country.[13] In addition, the residence country would relinquish a tax that stands in the way of the competitiveness of its own enterprises.

One must recognize that the solution for territorial taxation does not necessarily exclude a home country from applying residence-based income tax principles to its own corporate enterprises. A system that taxed worldwide income excluding only foreign active business profits would be likely to increase the U.S. tax base significantly.[14] The difficulty with taxing capital income to a corporation, however, is that there are already many possibilities for its avoidance through financing and tax shelters. In addition, capital income and interest deductions are often used to manipulate tax implications of business income and loss in the foreign context. Consequently, nations face constant erosion of their tax base with regard to both the capital and operating income of both domestic and *foreign* corporations.

Even in the case of countries such as the United States that have the power and the political will to tax worldwide corporate capital income, taxation of corporate capital income is not an optimum solution. The equity from an international perspective of assigning the exclusive tax base on economic rents to the country that added that value to the world is self-evident. The nation that created the value should be the nation that has the exclusive right to tax (or not to tax). This regime would ensure the competitiveness of U.S. business overseas without the artificial incentives created by an arbitrary and inconsistent international tax system.

[8]*See* Barker, *supra* note 3, at 377-381.
[9]*See* Barker, *supra* note 4, at 213.
[10]Avi-Yonah, *supra* note 1, at 390.

[11]*See* Barker, *supra* note 3, at 368-381. In general, taxes on foreign capital are passed on to the debtor in the form of additional interest.
[12]*Id.*, at 382-383.
[13]*Id.* at 383-387.
[14]*See* Rosanne Altshuler and Harry Grubert, "Where Will They Go If We Go Territorial? Dividend Exemption and the Location Decision of U.S. Multinational Corporations," 54 *Nat. Tax J.* 787, 798 (2001), who proposed excluding from the tax base the dividends paid by foreign corporations out of active business income.

In addition, there is a real question whether the taxation of the income from capital earned by a corporation is appropriate. The United State's classical response has been economic double taxation of such income classified as equity. Income from capital earned by a corporation is different, however, from the income that is composed of economic rents because the normal return on capital ultimately is derived from the investment of individuals, whereas economic rents are the true products of a business enterprise that are often made possible by the corporate form of doing business. An expenditure tax "ignores the income tax problem of the bias toward present consumption, treating present consumption and greater future consumption as equal where the present discounted value of future consumption is the same as present consumption."[15] It would largely eliminate the artificial debt equity distinction for tax purposes and most of the reasons for corporate tax shelters. It reduces international tax competition to competition for mobile economic rents.[16] Application of a territorial expenditure tax domestically would insure a substantial tax base for the United States with regard to both domestic corporations and foreign corporations operating in the United States because corporations are in the business of earning economic rents.

Finally, an expenditure tax for corporations leaves capital income taxation exclusively as a tax on creditors and shareholders. It eliminates economic double taxation of capital income. This is the only effective and economically efficient way to tax this income.[17] The owners of capital are the residents whose obligation to pay tax is based on ability to pay and who can be appropriately subjected to progressive income taxation. This reform of the corporate system would preserve income taxation, based on the equity of ability to pay, as the primary tax that *people* pay.

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[15]*See* Barker, *supra* note 3, at 382.
[16]*See* Barker, *supra* note 2, at 374-375.
[17]*See* Barker, *supra* note 3, at 195-197.